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**INVESTMENTS**
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Irish Life

# INVESTMENT OUTLOOK

## AUTUMN UPDATE

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Irish Life Investment Managers are part of the Great-West Lifeco group of companies, global leaders in financial services, with €49 billion* in assets under management on behalf of our Irish and International clients. We continually endeavour to apply our extensive and award winning expertise, now with the global experience and backing of Great-West Lifeco, to deliver class leading service and products to our customers, domestic and international alike.

*Source: ILIM, correct as at 31/7/2015.

European Pensions AWARDS 2014
WINNER
Equities Manager of the Year

European Pensions AWARDS 2014
WINNER
Passive Manager of the Year

Irish Pensions AWARDS 2013
WINNER
Innovation Award

Irish Pensions AWARDS 2013
WINNER
Investment Manager of the Year

Irish Pensions AWARDS 2013
WINNER
Communication Award

Until recently, 2015 appeared to be another fairly straightforward, and positive, year for markets and investors alike. However, issues in Greece and China have shown how confidence, when tested, remains fragile. In this issue of the Retail Investment Outlook, we examine the cause and effect of events year to date and how the rest of 2015 may unfold.

Thankfully, and notwithstanding market events, it has been another very successful year for the flagship Irish Life Multi Asset Portfolio Funds (MAPS) which passed through €1bn in assets in July. That makes Irish Life MAPS the largest retail multi asset portfolios in Ireland in terms of assets under management. We share some valuable insights from the investment team behind this success on how the property, bond, alternative and equity markets contributed to performance and look at the environment facing investors into 2016.

# CONTENTS

# SECTION 1

## INTRODUCTION

### MARKETS PAUSE FOR THOUGHT IN 2015 BUT WHAT FOR 2016?

The introductions to recent editions of the Investment Outlook have broadly followed a similar theme...markets have done well, investors have been rewarded and the outlook was positive. At the halfway point this year, it looked and felt like 2015 was going to be more of the same. Sure, there were some rumblings in Greece but markets were marching on regardless. Then, a shock Greek referendum result in early July sent markets in the opposite direction as the Euro project once again came under the watchful eye of investors around the world. Conversations that were last had in 2011 about countries exiting the Eurozone and the demise of the Euro currency were dusted down and recycled. In the first real test of market confidence for some time, once again money talked and money walked. Confidence and stock markets go hand in hand – when one goes, the other is not far behind.

#### TROUBLE IN CHINA...

Then China happened. Unlike the European situation, interventions by the Chinese government to restore calm were largely unsuccessful and possibly made matters worse. China represents 15% of global GDP, so if there is a problem in China, it is a problem for everyone. Investors reacted swiftly, selling aggressively and sending the volatility index (VIX) to its highest levels since 2011, when Europe and the global economy were at a far more perilous stage of recovery. For now, the worst of that storm appears to have passed and fears of a hard landing in China have receded, although not gone.

#### NO NEWS ON RATES FROM THE US...

Investors have also had to contend with the ongoing 'will they, won't they' raise US interest rates. Although commonly accepted that the Federal Reserve will raise rates, but debate rages on as to when and by how much. The most recent commentary suggests it could now be a 2016 event. While a potential rate rise has had a significant impact on the value of the dollar versus other currencies, the real impact on investors is that it adds further to market uncertainty. Uncertainty undermines confidence and confidence is fragile.

#### GOOD NEWS AND BAD NEWS FOR MARKETS AHEAD...

So if markets could talk, what would they be saying to investors? Well, I think they would say there is some good news and some bad news. The bad news is:

- Volatility is likely to continue in the short term driven by uncertainty over the outcome in Greece
- Slowdown in Chinese GDP growth
- The uncertainty of timing and size of rate increases in the US and UK
- Potentially disruptive Spanish elections in December.

However, I think the markets would also say there is good news ahead, namely:

- Although market volatility spiked severely in August, it has since return to more normal levels around its long term average.
- Opportunity knocks - short, sharp moves in stock markets are unsettling for investors in the short term, they can also throw up investment opportunities. The recent pull back in stock markets has meant that equities are now more attractively priced and for the longer term.
- The case for equities is even stronger when compared to other asset classes, particularly bonds. The dividend yield on equities now compares even more favourably with the income available on most bonds. Furthermore, the capacity for capital gain on bonds is limited and far lower than what is potentially available in equities.

In fact, outside of property and alternatives, we see equities as a key driver of returns over the next 12-18 months. As such, investors in equities will need to look at innovative ways to manage the risk associated with searching for higher returns in the event of a future significant market fall.

# Summary

- Volatility pick up in second half of 2015 and likely to continue in the short term.
- Market pull back offers opportunities in equity markets.
- Equity market growth looks underpinned by several factors:
  - Accommodative monetary policies globally
  - Valuations look attractive in absolute terms and relative to other assets
  - Inflation likely to remain low
  - Company earnings and economic data appear resilient.
- Bonds still offer some safe haven status should markets deteriorate but longer dated bonds may deliver significant short term capital losses should the interest rate cycle move higher or faster than anticipated.
- Irish Commercial property remains strong with demand outstripping supply in the key prime office market.
- Alternatives are increasingly going to represent an opportunity for investors to invest outside of the traditional assets and regardless of whether markets rise or fall.
- Equities likely to drive investment returns.

There is no doubt that 2015 has been a year of change and uncertainty but also opportunity. It feels like this market environment is set to continue into next year which is why Irish Life has never been more committed to supporting you. Let our experience, expertise and award winning investment team support your investment decisions in 2016.

Wishing you success into the end of 2015 and beyond,

**David Haslam**
**Head of Retail, ILIM**

# IRISH COMMERCIAL PROPERTY

## ACTIVITY DRIVING PRICING

# SECTION 2

## IRISH COMMERCIAL PROPERTY

- **Irish Commercial Property market activity continues apace**
- **Returns to be driven by rental growth**
- **Irish Life Property fund recent acquisitions**
- **Property Market Outlook 2015/2016**

Property investment activity in the Irish market continues to be strong with a total of €700 million of direct Irish investment property transacted in Q2 2015, which brings investment volumes in commercial property to €1.7 billion at the mid-point of 2015. With the banks expected to release more assets on to the market in H2, combined with the resale of properties by early loan/portfolio buyers and the strong level of demand continuing, turnover for the year could reach €3.5 billion.

### MULTIPLE BUYERS OF IRISH PROPERTY...

New investors of differing risk profiles continue to arrive on our shores and actively participate. Noteworthy transactions by new entrants this year include the Starwood REIT purchase of the Lonestar Dublin Office portfolio for over €500m, Union Invests acquisition of 2 Facebook buildings at Grand Canal Square in the South docks and their development funding of the Burlington Road office scheme for an aggregate commitment of over €400m, the Davis Kempner purchase of the Cornerstone shopping centre portfolio for €117m, and the Abu Dhabi Investment Authority's purchase of the former Jurys site in Ballsbridge for €170m. Irish Life continues to be active in the market acquiring two office buildings in the IFSC and one in Ballsbridge, in addition to the Sovereign Portfolio of prime Central Dublin retail shops.

### CURRENT BUYING OPPORTUNITIES...

One of the most high profile loan sales currently underway is the sale of Project Jewel, which includes Dundrum Town Centre and 50% interests in both The Pavilions and ILAC shopping centre, which is expected to be keenly bid by major international investors. We expect pricing to be keen and have a positive impact on prime shopping centre values. Prime property yields edged keener, with the prime office yield now approaching 4.5%, the prime high street yield is at sub 4% and the prime industrial yield at 6.5%. Limited additional yield compression is anticipated; however current levels remain attractively priced against long bond yields.

### RETURNS TO BE DRIVEN BY RENTAL GROWTH...

Take-up of space in the Dublin office market reached 1.2 million sq. ft. for H1 2015. Knight Frank reported that the strong occupier confidence is reflected in the financial services sector accounting for 36% of take-up in H1 including the Bank of Ireland pre-letting of 129,500 sq. ft. at 27-33 Baggot Street. Most of the demand for office space is still focused on the city centre as Dublin 1, 2 and 4 account for 65% of take-up. According to JLL, the Dublin office vacancy rate has dropped to 8.6% in Q2. The availability of prime office space in central Dublin continues to diminish with the current city centre vacancy rate of 5.2% compared to 12.6% in the suburbs. Office space under construction in the city centre has risen to 1.7 million sq. ft. of which 55% is pre-let while there is an estimated 1 million sq. ft. under refurbishment. Prime office rents have reached €50 per sq. ft. and are set to continue increasing until new supply in the development pipeline is delivered to meet tenant demand.

### IRISH LIFE IRISH PROPERTY FUND ACQUIRES GREAT ASSETS

The Irish Life Property fund has continued its active acquisition programme through the first half of 2015 by the successful acquisition of a number of high quality property assets, to enhance and further diversify its property portfolio.

### HARBOURMASTER 1 IFSC NORTH DOCKS, DUBLIN 1.

The Fund purchased Harbourmaster 1, a prominent Grade A office building in the IFSC for €50m, which reflects an income yield of c.6%. The property is a 7 storey over basement office building measuring 62,000 sq.ft and is let in its entirety on an full repairing and insuring lease to KPMG, with over 11 years unexpired on the lease.

Harbourmaster 1, Dublin 1

There has been a lot of institutional investment activity in the IFSC and northern Docks recently given the existing strong fundamentals as well as a bright outlook which will see increased development and improved infrastructure, including Luas cross city, further enhancing the connectability of the IFSC and the areas critical mass as a whole, challenging Dublin 2 as Dublin's premier office location.

## MCDONALDS GRAFTON STREET AND HODGES FIGGIS DAWSON STREET, DUBLIN 2

Irish Life has recently completed the acquisition of the €150 million Sovereign Portfolio from Royal London Asset Management. The purchase followed a competitive open market sales process with offers from both international and domestic institutions. In purchasing the portfolio, Irish Life has acquired one of the most unique collections of prime retail properties offered for sale in the Irish market. The portfolio offers a rare opportunity to acquire a substantial holding in Dublin's prime retail districts including flagships stores such as McDonalds on Grafton Street and Hodges Figgis on Dawson Street.

9-11 Grafton St, Dublin 2

56-58 Dawson St, Dublin 2

## PROPERTY MARKET OUTLOOK 2015/2016

These acquisitions give the Irish Life Property Fund additional exposure to exceptionally strong retail properties at an early stage in the retail rental recovery cycle. With improving consumer confidence and increasing retail sales sparking renewed demand from retailers for strong high street locations, retail rents are strengthening, which will impact positively on property values.

## THE OUTLOOK FOR PRIME RETAIL UNITS...

The outlook for prime Dublin high street retail units, shopping centres and retail parks is strengthening with positive rental growth emerging particularly on Grafton Street. One of the sectors that continues to trade particularly strongly is the food and beverage/restaurant sector with strong competition prevailing for good opportunities.

## *Summary*

Demand looks set to remain high across the Irish Commercial Property market. The concentration of interest both domestically and internationally on prime offices and prime retail are likely to keep prices rising, where precious few opportunities to acquire remain. Equally, properties for rent in these market sectors are likely to see sustained downward pressure on yields into 2016, as supply looks set to be outpaced by demand over that period and beyond. Indeed, market forecasts are indicating 2018 as the earliest we are likely to see current pipeline developments come to the market other than smaller one off projects. Should that prove to be the case, Irish Commercial Property is likely to have another positive year in 2016.

Martin O'Reilly
Head of Property, ILIM

# EQUITY MARKETS

## DRIVING RETURNS ON A BUMPY ROAD

# SECTION 3

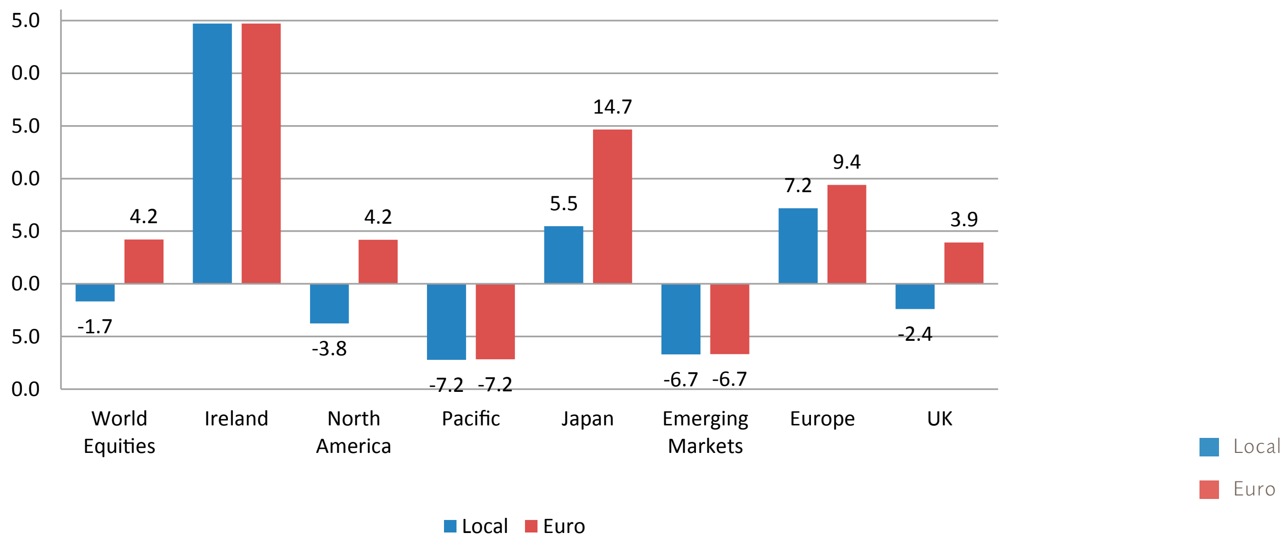
## EQUITY MARKETS

- Summary of 2015 to date
- Equity Market Outlook
- China and Global Growth
- Interest Rate environment
- Equity Market valuations
- Summary

### YEAR TO DATE IN 2015...

Equity markets have been quite mixed year to date with higher levels of volatility compared to recent years. Having generated positive returns through much of the first half of the year, markets fell sharply in August on growth concerns in China and fears over possible contagion to the global economy. As a result, global equities markets fell -1.7% in local currency terms by early September. However, given weakness in the Euro since the beginning of the year, equity markets have been positive in Euro terms, up +4.2%.

MARKET RETURN YEAR TO DATE (AS AT 3 SEPTEMBER 2015)




Source: Factset, September 2015

### POSITIVE FIRST HALF

Through much of the first half of the year, global equities experienced a steady, gentle uptrend. This was supported by the larger than expected €60bn per month asset purchase programme which was announced by the ECB in late January and implemented in early March. The open ended nature of the programme was also a positive surprise for markets. While due to run until September 2016, the ECB also included a proviso that the programme would continue until such time as inflation returned on a sustainable basis back to its target of just below 2%. This opened the possibility of extending the programme either in size or time beyond September 2016 if inflation failed to rise. Combined with the increase in asset purchases announced by the Bank of Japan in October 2014, this ensured that the balance sheets of G4 (US, UK, Europe, Japan) central banks would expand 20% faster pace in 2015 than 2014, despite asset purchase programmes in the US Fed only finishing in October 2014. The continued fall in global inflation following the collapse in oil prices in the second half of 2014 also facilitated over twenty central banks in lowering interest rates in the first half of the year providing further support to equity markets. While global economic growth was slower than expected, particularly in Q1, equity markets were initially able to shrug this off on the expectation that growth would improve through the remainder of the year and a weather related hit to US growth in the early months of the year expected to fade. Company earnings also tended to surprise positively, principally in developed markets, following downgrades to earnings forecasts late in 2014 and early 2015. These were centred mainly on the energy and materials sectors due to falls in oil and commodity prices. On a valuation basis, in absolute terms, equities traded around historic averages through most of the first half of the year although on a relative basis they remained very attractive compared to other asset classes such as bonds and cash, given the low levels of yields available on these assets. This also contributed to the positive returns in equities in the earlier part of the year.

### GREECE

Through the summer months, equities saw some increased levels of volatility and uncertainty mainly related to the Greek crisis. Concerns peaked in early July following the imposition of capital controls although ultimately, given the potential negative consequences for Greece if they exited the Euro, a compromise was reached. It did not include any reduction on Greek debt initially but is subject to review later this year which could include extensions of maturities on Greek loans, additional reductions in interest rates charged on these loans or extensions of interest free periods on loan repayments. The Greek parliament has passed legislation which commits the government to implementing the requirements and reform restructurings required under the new bailout programme which should facilitate the successful implementation of the programme. The upcoming general election in late September should also provide greater stability in terms of the Greek government, further aiding the much needed reform process in the country. The agreement in principle in mid-July to implement the bailout programme helped restore a temporary calm to markets through late July and led to a rebound in global equities through the month.

### AUGUST WEAKNESS

Markets began to sell off again in August, mainly due to concerns around the ongoing slowdown in the Chinese economy. As China has been viewed as one of the main engines of global growth in recent years, any risk to their growth outlook has been seen as a threat to global growth. While slowing in recent years, fears over the extent of the slowdown were heightened in early August by a surprise devaluation of the Chinese currency, the Renminbi (Rmb). This move was viewed by investors as a policy response to stimulate exports and overall growth and a signal that growth was slowing at a more rapid pace than previously evident. Given the sensitivity of global growth to a hard landing in the Chinese economy, global equity markets sold off sharply, particularly in the second half of August as chart support levels were broken and hedge funds reduced exposures in the face of rising volatility in markets. The significant falls in the last week or so of August wiped out all the year to date gains in global equities in local currency terms.

## EQUITY MARKET OUTLOOK

Post the recent fall in equity markets, what is the outlook now for global equities? We believe the outlook remains positive with recent concerns over the extent of the Chinese economic slowdown and its impact on the global economy overdone. Further upside in markets is supported by a number of factors and while the increased volatility evident over the last 12 months in markets could well remain a feature, the overall trend still appears to be upward.

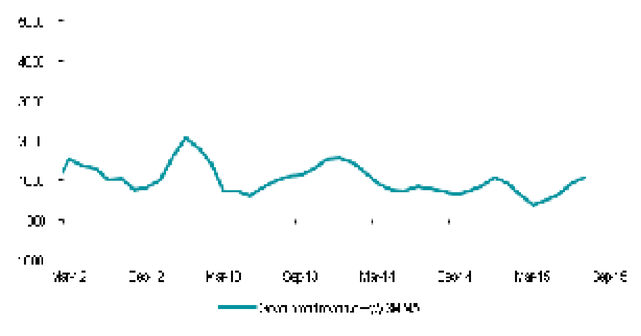
### ECONOMIC BACKDROP

Growth in the global economy has proven to be slower than initially expected averaging about 2.3% in the first half of the year. Weakness, compared to expectations of just over 3%, was partially due to weakness in the US in the first quarter but mainly due to continued deterioration in data from emerging markets outside China.

### CHINESE ECONOMY

While growth in 2015 to date has been modestly lower than expected, global growth concerns heightened in August, centred on the Chinese economy. It has been accepted that growth in the Chinese economy has slowed from the 10% + rates evident pre-crisis to approximately 7% based on official GDP releases. While official data showed an improvement in Q2 growth to an annualised rate of 6.8% (from 5.2% in Q1), investors have suspicions over the accuracy of data releases in China. The fear is that the economy is deteriorating at a more rapid pace than the official data is suggesting. To overcome this, investors have turned to other data points to gauge the level of growth in the economy. One such measure is the growth in tax revenues, shown below, which is viewed as a more reliable indicator of activity trends in the economy. As can be seen, while growth in tax revenues has slowed somewhat over the last three years, it is still growing at a reasonably strong rate of 9.5%, suggesting underlying growth remains relatively strong.

GOVERNMENT REVENUE %Y/Y 3M MA



Source: Exane BNP

Other indicators such as railway cargo shipments, power consumption and lending trends also suggest that growth, while lower than the official estimates of around 7%, is still running at c. 5% or slightly above. The most recent retail sales data shows growth of 10.3% y/y and signs of stabilisation in the property market indicate the economy remains well underpinned. Thus, while growth has slowed in China, more reliable data points in the economy suggest that China is not moving towards a hard landing but instead is maintaining growth at still very strong levels of approx. 5%. On this basis the concerns evident in the market regarding the pace of Chinese growth appear overdone.

## CHINESE CURRENCY DEVALUATION

China has been attempting to get the Rmb included in the IMF's Special Drawing Rights (SDR) basket of currencies. The SDR in effect is a unit of reserve currencies in which managers of foreign exchange reserves hold about 4/5% of the reserves they manage. In early August, the IMF indicated it was delaying its decision on the inclusion of the Rmb in the SDR basket until later this year, citing the lack of flexibility and concerns over the process for setting the daily exchange rate as one of the reasons for the delay. The subsequent decision to devalue the currency and introduce more flexibility in the determination of the exchange rate was probably a more politically motivated decision to try to get the Rmb's included in the SDR basket rather than an indication of a worsening domestic economic environment. As a result, investors increased concerns over the growth outlook specifically arising from the recent currency devaluation could be overdone.

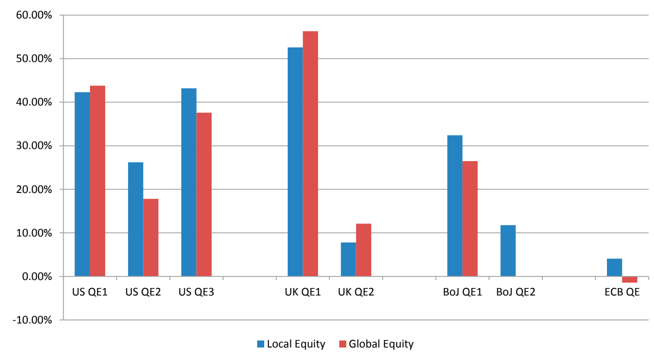
## GLOBAL GROWTH INDICATORS

Economic releases in developed markets have remained resilient and strong. The global composite Purchasing Managers Index (PMI) remains above the threshold breakeven level of 50 at 53.7 and is consistent with growth in the global economy of 2.7%. Retail sales and consumption data in the US indicate consumer spending is rising at over 3% annualised and the labour and housing markets have continued to improve. The composite PMI in the Eurozone recently rose 0.4 to 54.3, a four year high, and is consistent with growth in the economy of 2% (versus 1.6% in the first half of 2015). GDP grew 2.6% y/y in Q2 in the UK while retail sales are running at 4.2% y/y. So, while global growth remains below the levels evident pre-crisis, it remains solid, particularly in developed markets. The expectation is for modest improvement, supported by improving labour and housing markets, lower oil prices, low interest rates and accommodative monetary policies. While growth has slowed in China, data indicates the economy is unlikely to threaten global growth in the near term.

## MONETARY SUPPORT

Equity markets have benefited in recent years from global central banks low interest rate policies. The chart below highlights the local stock market moves when Quantitative Easing (QE) programmes have been implemented both in the local market and in global equities. On average, local equity markets have risen on average by 28% and global equity markets by 24% while these QE programmes have been implemented.

## EQUITY MARKET MOVES DURING QE




Source: Factset

## ECB POLICY OUTLOOK

Eurozone inflation is unlikely to be close to the ECB's target of just below 2% by September 2016, particularly given the renewed weakness in oil prices in recent months and a slower Chinese economy. As a result, it is likely that the ECB will extend in size and/or length its current level of asset purchases to ensure policy targets are met. ECB President Draghi also indicated that the asset purchase programme is flexible and can be expanded in terms of composition.

## JAPAN POLICY OUTLOOK

The Bank of Japan also has a 2% inflation target to meet by the second half of next year. Recent developments in oil and commodity prices, emerging market currency trends and Chinese growth patterns have increased the probability of missing those targets. Thus, further expansion of existing monetary stimulus programmes in the Eurozone and Japan are possible in coming months which should be supportive of global economies and equities.

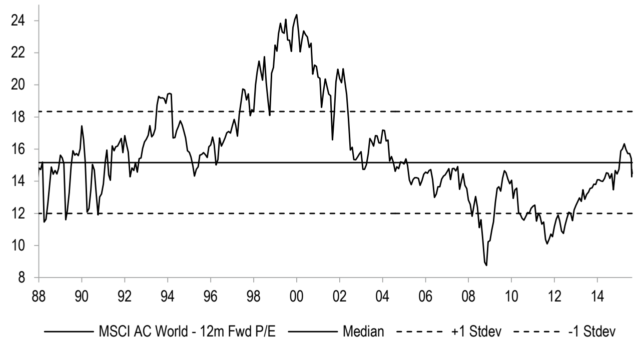
## US AND UK INTEREST RATES

Recent events have further delayed the timing of the first interest rate rise in both the US and UK. While the US labour market has continued to strengthen, it has not translated into wage inflation pressures which have remained very stable at around 2%. The strength of the US dollar on a trade weighted basis and lower oil prices have also kept inflation lower than previously expected in the US. The Fed has indicated that the pace of any tightening cycle is more important than the exact timing and the progression of rate rises will be very gradual. Currently the market expects the first interest rate rise in the US in Q1 2016. Expectations for the first UK rate rise have also been pushed out to Q3 2016 as strength in sterling, lower oil and commodity prices, evidence of improving productivity and some easing in wage pressures have been viewed as easing inflation pressures. The delay in the UK/US together with a more gradual rate increases than in previous cycles, is also supportive of equities.

## EQUITY VALUATIONS

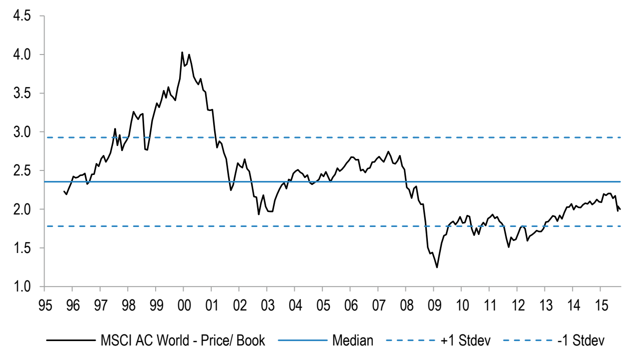
Following the recent weakness in markets, global equities are now attractive on many valuation measures, tending to trade below historic averages. In terms of the price/earnings (P/e) ratio based on 12 month forward earnings estimates, global equities are trading at about 14.5x compared to a longer term average of 15.2x. In an environment of relatively low interest rates and inflation (by historic standards) with a modestly improving global economic growth, equity valuations have scope to move higher. Within this economic backdrop, global earnings can grow in the region of mid to high single digits in coming years which provides upside in equities even in a situation where valuation multiples remain unchanged.

### GLOBAL EQUITY 12 MONTH FORWARD P/E MULTIPLE




SOURCE: JP MORGAN

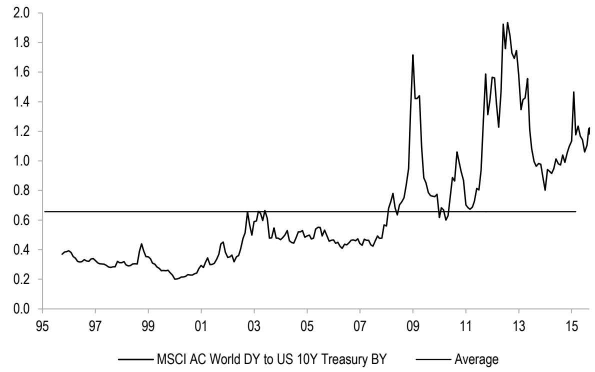
Similarly on a price/book basis, at 2.0x, global equities are approx. 17% below their long term average after the recent fall in markets.




SOURCE: JP MORGAN

On a relative valuation basis, global equities continue to remain extremely attractive relative to bonds. The chart below compares equity valuations relative to bonds by dividing the global equity dividend yield by the yield on US 10 year treasuries (a proxy for global bonds). Currently the relative yield on equities remains attractive compared to the yield on bonds and is significantly above the average relative yield between the two assets over the long term, highlighting the relative attractiveness of equities versus bonds.

### GLOBAL EQUITY DIVIDEND YIELD V'S BOND YIELDS



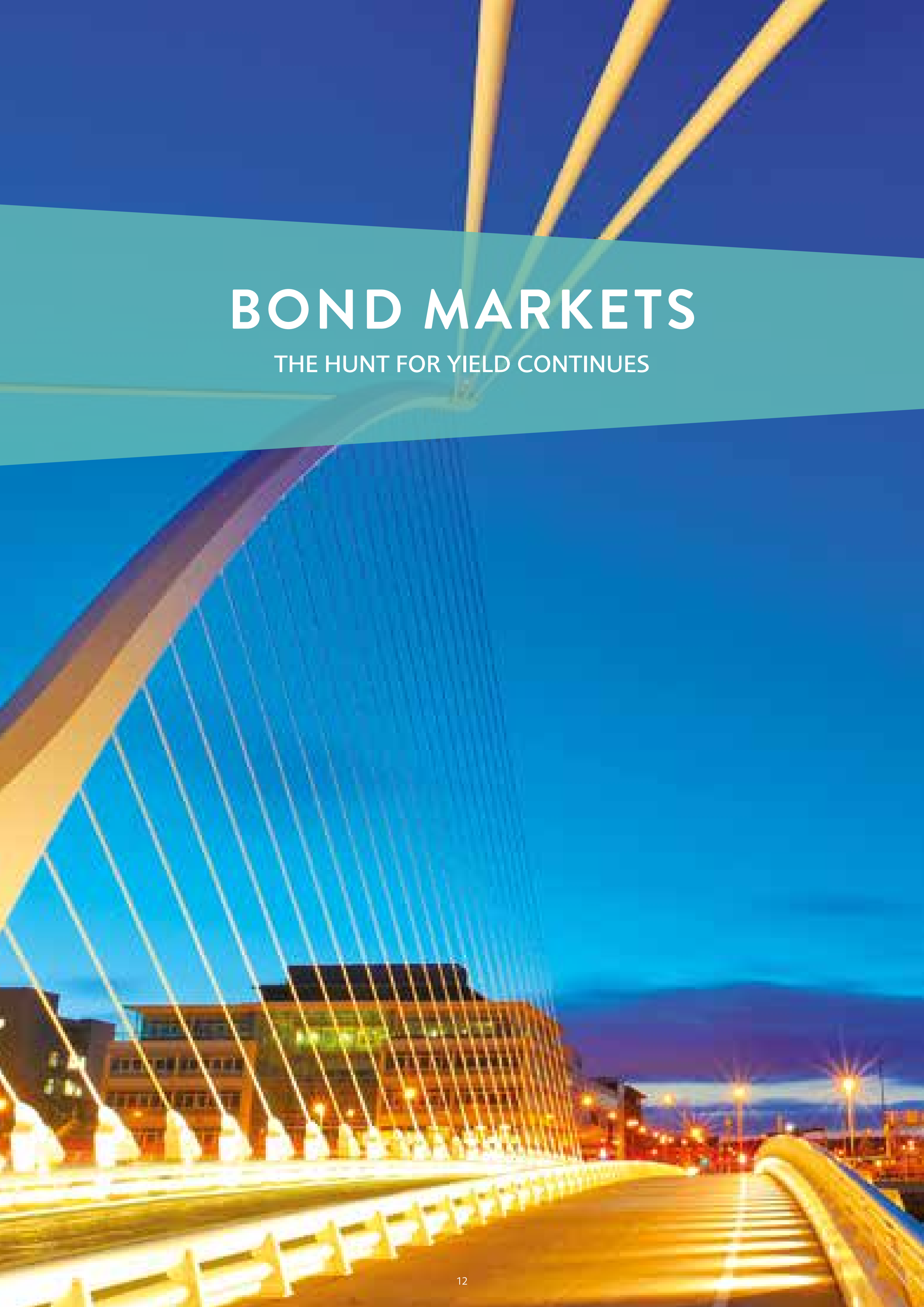

SOURCE: JP MORGAN

## Summary

Despite the lacklustre returns in local currency terms year to date, we believe equities still provide upside and continue to be supported by a number of factors.

- The recent concerns over Chinese growth appear overdone and as these concerns ease and confidence returns in relation to Chinese and global growth prospects, equity markets should reverse their recent declines.
- The global economy should continue to experience a modest and slow growth path without the risk of falling back into recession. This in turn should enable interest rates and inflation to remain low while earnings can continue to grow in the region of mid to high single digits, further helping equity markets move higher.
- Global monetary policy remains supportive and given recent renewed falls in oil prices and deflationary impulses from weaker growth and currencies in emerging markets, should remain in place for longer than previously expected.
- Equity valuations are attractive in absolute terms and remain extremely attractive relative to other asset classes, particularly bonds and cash. Gains of mid to high single digit from global equities are possible in coming months in local currency terms and if the Euro continues to weaken, gains could be higher.
- Volatility likely to remain with issues such as elections in Spain, the exact timing and extent of rate rises in the US and UK, Chinese and global economic news flow and concerns over possible deflation.

**Lenny McLoughlin**
**Chief Economist, ILIM**



# BOND MARKETS

## THE HUNT FOR YIELD CONTINUES

# SECTION 4

## BOND MARKETS

- **2015 First Half Review**
- **Q3 Review**
- **2015/2016 Market Outlook**

Following the strong returns of the second half of 2014, the first half of 2015 showed a more mixed bond market return with the Merrill Lynch Eurozone Government bond index showing a return of -0.03%.

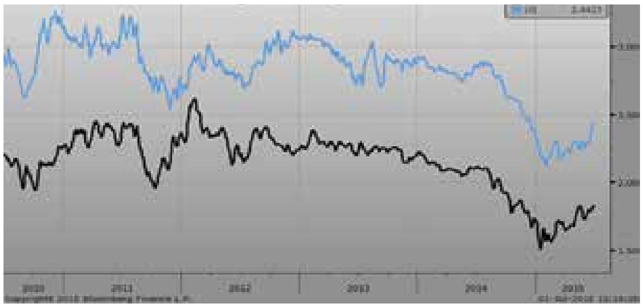
### US MARKET...

After another weak winter with a Q1 GDP growth of 0.6%, the US economy showed signs of a recovery in Q2 with an annualised growth rate of 3.7% and continuous strong employment growth. Members of the US Federal Reserve pointed towards a first rate hike in 2015 albeit the probability of such a move at the September meeting had dropped from 60% to about 40% by the end of Q2.

### BACK IN THE EUROZONE...

In the Eurozone, January 2015 saw the announcement of large scale quantitative easing (QE) by the ECB. This meant they would buy €60bn per month of Eurozone Government, Quasi Government and Covered bonds until at least September 2016 in the market. The sum equates to about 220% of the Eurozone Government bond net issuance. ECB bond purchases dominated the Eurozone bond markets early in H1 with 10 year German Government bond yields reaching an all-time low of 0.05%. However, a steady uptick in Eurozone inflation from the lows of -0.6% to a May inflation of +0.3% together with an improvement in economic growth scared bond markets from late April onwards. Longer dated bonds which are highly sensitive to inflation, and inflation expectations, sold off and the 10 year German benchmark reached a high of 1.07% during the second quarter but finished at 0.77% as a result of Greek uncertainty. With several debt deadlines expiring at the end of June, Greece was the dominant issue for Eurozone bond markets for the second half of Q2 and peripheral market spreads widened on the prospect of a possible Greek exit from the Eurozone.

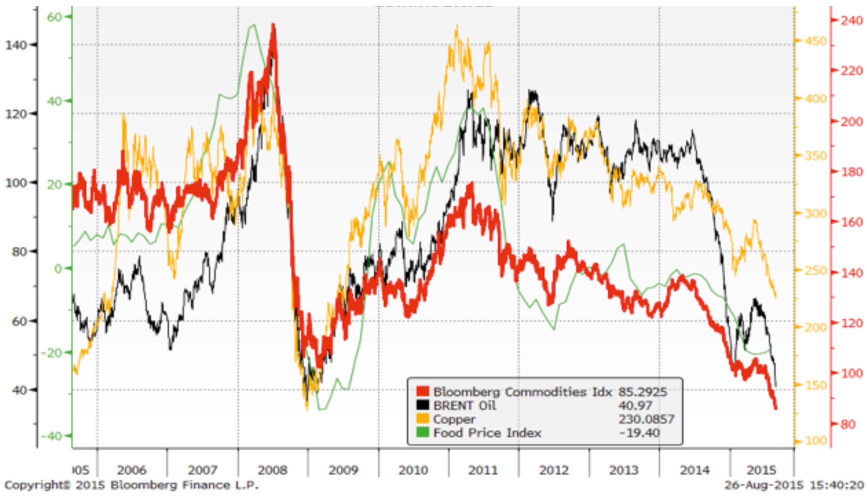
RISING INFLATION EXPECTATIONS



## 2015 BOND MARKETS – Q3

Following the agreement with Greece in July and the disbursement of the first new tranche of financial aid, the focus of the Eurozone bond markets has shifted towards global economic growth, inflation and the timing of the first rate hike by the US Federal Reserve. However, during the month of August concerns about an economic growth slowdown in China came to the fore, especially as China was forced to devalue its currency to stimulate its domestic economic growth. The slowdown fears in China spilled over into weakness in commodities with oil (BRENT) dropping below the $45 mark and fed through to strongly reduced inflation expectations. The graph below shows the renewed sell off in commodities in the second half of 2015 with the Bloomberg Commodities Index (red line) reaching a new 10 year low.

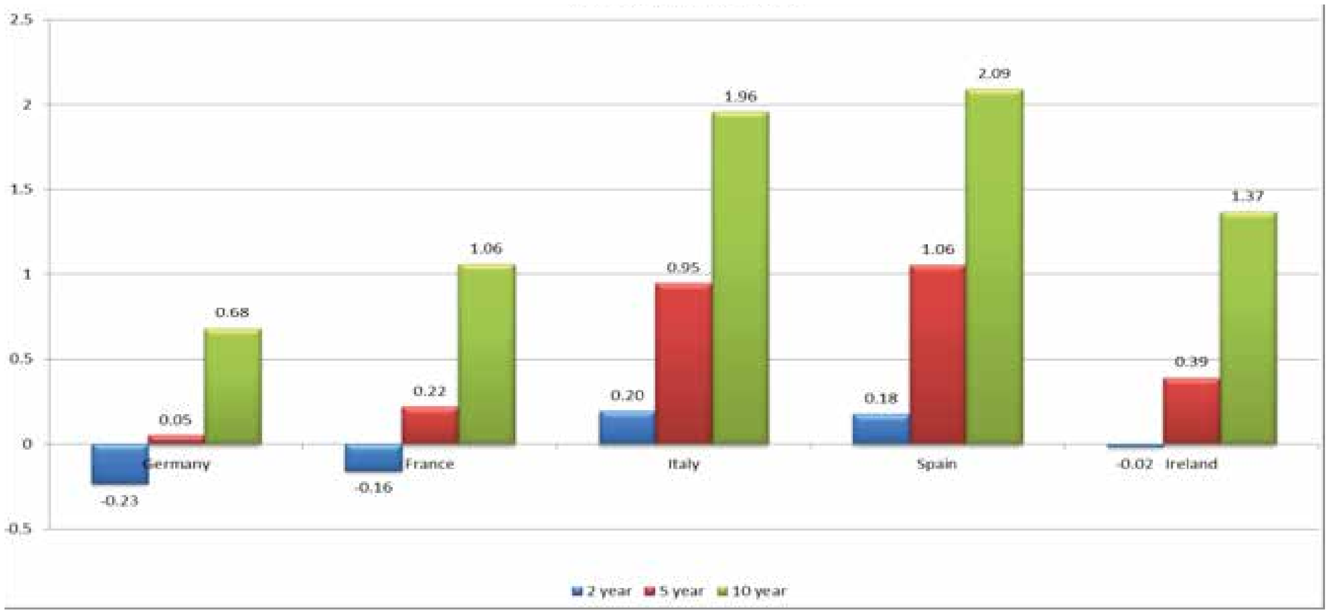
COMMODITIES




Source: Bloomberg

The resulting benign global economic growth and inflation outlook led to a further reduction of bond yields in Q3 with Eurozone Government bonds still receiving the benefit of the ECB purchasing program. The following chart shows Eurozone bond yields in late August:

EUROZONE BOND YIELDS




Source: Bloomberg August 2015

## 2015/16 Bond outlook...

Global economic growth and its impact on inflation will be closely watched by bond markets for the coming months. Leading indicators currently point towards a modest growth pick-up in the Eurozone, Japan and the US while concerns about a further slowdown in China and Emerging Markets persist. However, with a devaluation of its currency and interest rate cuts, the Chinese authorities are actively trying to promote growth with a good possibility of a stabilisation of the economy into year end. But with a strong supply overhang in various commodities and low global wage growth there seems little evidence that we will experience a meaningful uptick in inflation over the coming months.

As discussed previously, the US Federal Reserve is looking for an opportunity to move away from current low interest rates. For such a move the US Fed has named 3 conditions that need to be met to achieve "lift-off":

- Strong employment data
- Higher inflation
- A stable US Dollar

With an unemployment rate at 5.6% and strong monthly jobs growth data, the first point has been met in recent months. However, the other targets of higher inflation and a stable US Dollar have not been met so far. Given the weak Euro and the devaluation of the Chinese Yuan, the trade weighted Dollar has reached new highs in 2015 and is currently about 20% higher on a year-on-year basis. This has reduced the probability of a Fed rate hike in September from 58% to as low as 15%. Even the probability of a rate hike by December has now been reduced from a near certainty to 48%. Nevertheless we still see a good chance that the Fed will want to put at least one rate hike in place in 2015 to get the process started ahead of 2016.

Under such a benign scenario Eurozone bond yields should be strongly anchored close to current levels as seen in the chart above. Even if the US Federal Reserve hikes rates earlier than expected low inflation and ECB support will be enough to ensure low bond yields for the coming months. Our current forecast range for 10 year German Government bond yields is 0.5% to 1% with a positive outlook for peripheral bond markets. Unless we see a strong rise of the protest parties in upcoming elections in Greece, Spain, Portugal and Ireland these markets should benefit from the hunt for yield with some further spread tightening a strong possibility.

**Max Plapp**
**Head of Bonds, ILIM**


# ALTERNATIVES

## AN INCREASINGLY CRITICAL PART OF ANY INVESTMENT PORTFOLIO

# SECTION 5

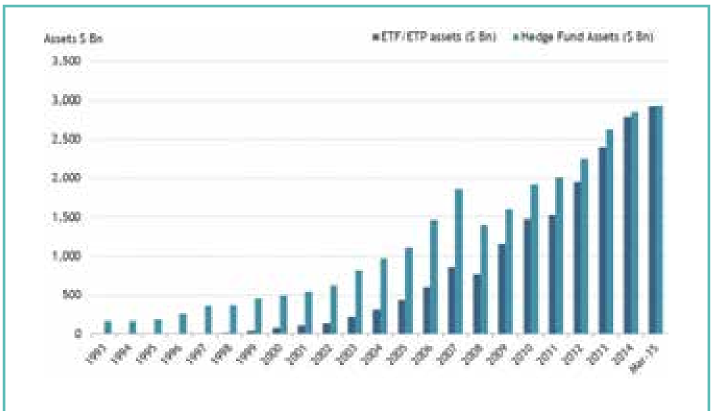
## ALTERNATIVES

### What are Alternatives?

'Alternative' investing involves making allocations to traditional assets such as equities and bonds using innovative investment strategies such as those undertaken by hedge funds, or investing in non-traditional assets such as infrastructure and forestry. Absolute Return strategies are implemented by Hedge Funds and investment banks and aim to make money regardless of the direction of market movements. As these strategies rely on the skill of the fund manager they can be more expensive to invest in than traditional assets. However, they can provide significant diversification benefits in an investment portfolio and typically see less volatility in returns.

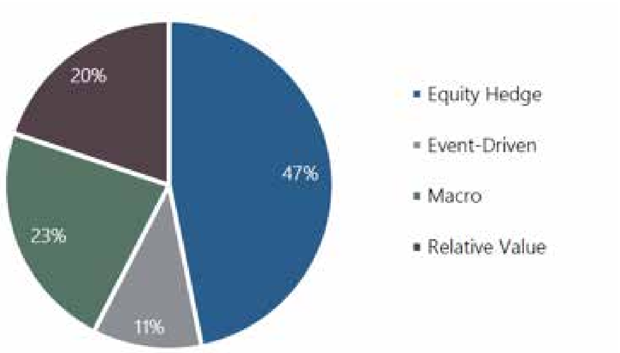
### INCREASING RETURNS WITHOUT INCREASING RISK...

As a result of their benefits to an investment portfolio, Absolute Return strategies have increased in popularity since their relatively recent inception. In recent years the trend of low yields in bond markets has encouraged investors to look at ways to increase the overall portfolio performance without taking on extra volatility. Market volatility throughout 2015 has increased investor appetite for these funds and it can be expected that these strategies will remain popular in future as a means of targeting portfolio returns. According to Hedge Fund Research (HFR), a global leader in hedge fund data and analysis, total industry capital being managed is $2.97 trillion globally (as illustrated below). This includes $39.7bn of inflows in 2015 There have been record inflows in some hedge strategy types this year as investors become cautious on market returns.

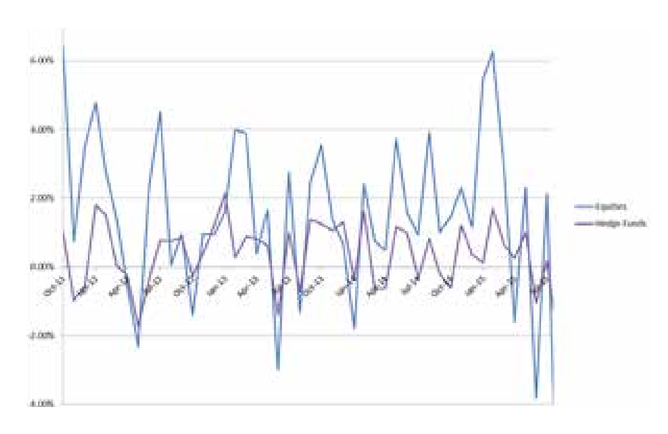



There are a large number of strategies and return streams open to hedge fund managers and there are four broad categories within this investment space; relative value, event driven, equity long/short and tactical trading. The following chart illustrates the relative size of each of these strategy types in the hedge fund space:

HFRI FUND WEIGHTED INDEX CONSTITUENTS




According to HFR, as illustrated below, hedge funds have returned -1% to date in 2015. This takes into account volatility in the third quarter resulting from market falls in China.



### WHAT ARE 'TACTICAL STRATEGIES'?...

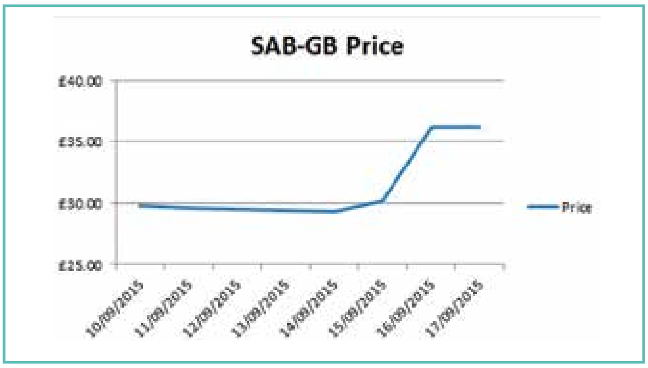
Tactical strategies, often referred to as Macro strategies, are trading approaches based on the movement of macroeconomic variables such as interest rates, trends in commodity and in particular currency markets. An example of market move that these strategies can benefit from is the fall in the euro versus the US dollar over the last two years shown below.


Source: Bloomberg

Broadly speaking, these strategies performed well for most of 2014 and 2015, although in some instances losses were incurred in August.

## HOW DO 'EVENT DRIVEN' STRATEGIES WORK?...

Event driven strategies seek to profit from events such as mergers and corporate restructuring. These events can result in very significant moves in security valuations. A recent example is the 19.8% increase in SABMiller's share price immediately following a takeover announcement by Anheuser-Busch InBev.




Source: Bloomberg

Event driven strategies performed well in Q1 with gains, as a group, of 2.58% but which fell as the year went on particularly in Special Situations and Distressed areas. Within the hedge fund industry, approximately 11% of assets under management are allocated to event driven strategies – a figure we think is unlikely to change in the near future.

## WHAT IS 'RELATIVE VALUE'?...

Relative Value managers seek to make gains from value discrepancies between securities. The underlying principle for relative value strategies is spread trading. By establishing long positions in undervalued assets and short positions in overvalued assets, relative value managers aim to capture profit opportunities that arise from the changing price relationship between the securities involved. Investors potentially profit from the "relative value" of the two securities. This area has performed well in 2014, and continues to perform positively in 2015.

## WHAT DOES 'LONG/SHORT' MEAN?...

Equity long/short strategies may take long positions in certain equities and equity derivatives in the hopes of profiting from gains in prices. Short strategies aim to benefit from falls in specific asset prices. A typical strategy would combine the two with either a long or short equity bias, depending on the manager's preference. This strategy comprises 29% of total hedge fund capital. The HFRI Equity Hedge Index gained +4.1% by half year 2015 in its best performance since 2010.

## Summary

In the current environment of low bond yields, low cash rates and equity market volatility, investors continue to seek alternative sources of returns and we expect the popularity of alternative investments to continue to increase going forward due to the benefits that they bring to a balanced portfolio.

Peter Haran
Head of Alternatives, ILIM

# INDEX PERFORMANCES AND MARKET DATA

# SECTION 6

## INDEX PERFORMANCES AND MARKET DATA

| Equity Markets (%) | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 YTD |
|---|---|---|---|---|---|---|
| ISEQ Overall Return | -0.1 | 2.6 | 20.5 | 35.8 | 16.8 | 27.5 |
| FTSE 100 TR | 12.6 | -2.2 | 10.0 | 18.7 | 0.7 | -2.9 |
| Euro Stoxx 50 TR | -2.8 | -14.1 | 18.1 | 21.5 | 4.0 | 5.6 |
| S&P 500 TR | 15.1 | 2.1 | 16.0 | 32.4 | 13.7 | -1.9 |
| Nasdaq Composite | 16.9 | -1.8 | 15.9 | 38.3 | 13.4 | 3.3 |
| Nikkei 225 | -3.0 | -17.3 | 22.9 | 56.7 | 7.1 | 5.6 |
| MSCI Emerging Markets | 11.7 | -14.9 | 13.9 | 0.9 | 2.6 | -6.0 |
| MSCI World | 7.8 | -7.6 | 13.1 | 26.2 | 7.7 | -1.6 |

| Sovereign 10yr Bond Yields (%) | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 YTD |
|---|---|---|---|---|---|---|
| US | 3.3 | 1.9 | 1.7 | 3.0 | 2.2 | 2.1 |
| German | 3.0 | 1.8 | 1.4 | 1.9 | 0.5 | 0.7 |
| UK | 3.4 | 2.0 | 1.9 | 3.0 | 1.9 | 1.8 |
| Japan | 1.1 | 1.0 | 0.7 | 0.7 | 0.3 | 0.3 |
| Ireland | 9.1 | 8.4 | 4.5 | 3.4 | 1.3 | 1.4 |
| Italy | 4.8 | 7.1 | 4.6 | 4.1 | 2.1 | 1.8 |
| Greece | 12.5 | 31.7 | 12.7 | 8.2 | 9.6 | 7.9 |
| Portugal | 6.6 | 13.4 | 6.9 | 6.1 | 2.7 | 2.5 |
| Spain | 5.5 | 5.1 | 5.4 | 4.1 | 1.6 | 1.9 |

| Central Bank Rates (%) | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 YTD |
|---|---|---|---|---|---|---|
| ECB | 1 | 1 | 0.75 | 0.25 | 0.05 | 0.05 |
| Bank of England | 0.5 | 0.5 | 0.5 | 0.25 | 0.50 | 0.50 |
| US Federal Reserve | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |

| Foreign Exchange Rates | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 YTD |
|---|---|---|---|---|---|---|
| Euro/Dollar (€/$) | 1.34 | 1.30 | 1.31 | 1.37 | 1.21 | 1.14 |
| Euro/Sterling (€/£) | 0.86 | 0.83 | 0.81 | 0.83 | 0.78 | 0.73 |
| Sterling/Dollar (£/$) | 1.56 | 1.55 | 1.61 | 1.65 | 1.56 | 1.56 |

Source: Bloomberg as at 18/9/2015

**Warning: Past performance is not a reliable guide to future performance**

# DISCLOSURE STATEMENT

This document is intended as a general review of investment market conditions. It does not constitute investment advice and has not been prepared based on the financial needs of objectives of any particular person, and does not take account of the specific needs of circumstances of any person.

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* Information correct as at 11/9/2015

** Equity market returns are total returns

# NOTES

PENSIONS
**INVESTMENTS**
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